No. 1

In the Supreme Court of the United States

OCTOBER TERM, 1939

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WILSHIRE OIL COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 54–56) is reported in 35 B. T. A. 450. The opinion and dissenting opinion in the Circuit Court of Appeals (R. 72–80) are reported in 95 F. (2d) 971.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 1, 1938 (R. 79). The petition for a writ of certiorari was filed June 30, 1938, and was granted April 3, 1939 (R. 82). The jurisdic-

tion of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Section 114 (b) (3) of the Revenue Act of 1928 allows an arbitrary deduction for depletion of oil and gas property in the amount of 27½% of the gross income from the property during the year, but provides that the "allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property".

In computing its taxable net income, the taxpayer deducted development expenditures. May it refuse to take these same deductions in computing net income for the purpose of applying the 50 per-cent limitation on the depletion allowance?

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in Appendix A, *infra*, pp. 30–31.

STATEMENT

The facts were stipulated and may be summarized as follows (R. 48–53):

The respondent is a California corporation engaged in the business of producing oil and gas from various properties located in Southern California (R. 48). In filing its income tax returns for the years 1929 and 1930, the respondent, pursuant to

the regulations, claimed and was allowed as deductions from gross income so-called development expenditures in the respective amounts of $606,051.66 and $279,927.04 (R. 52–53).[1] The respondent claimed that in determining its "net income * * * from the property" for the same years, for the purpose of computing the allowable depletion under Section 114 (b) (3) of the Revenue Act of 1928, the development expenditures were not to be deducted. The Commissioner, on the other hand, ruled that since the development expenses were deducted by respondent in determining its taxable net income they should likewise be deducted in computing its "net income" for the purpose of applying the 50 percent limitation on depletion under Section 114 (b) (3). Thus, for the year 1929, the Commissioner's computations with respect to the properties[2] involved are as follows (R. 52):

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[1] These figures include, in addition to actual development expenses, depreciation on equipment used for development purposes. No distinction is drawn between these two items by either party in this litigation, and as used hereinafter the term "development expenses" will be understood to embrace such depreciation as well.

[2] The present suit involves three properties for the year 1929, namely, the so-called Peterson, Baker, and Crawford leases. The same properties and, in addition, the so-called Buckbee lease are involved for the year 1930. For convenience, the computations shown above represent a consolidation of the computations with respect to the separate properties appearing on the schedule at R. 52.

Gross income from the properties		$1,001,375.17
Deductions:		
Production expense (Items 3 and 4)	$171,399.03	
Development expense (Items 1 and 2)	606,051.66	
Total expense		777,450.69
Net income from property (computed without allowance for depletion)		223,924.48
50 percent of that net income		111,962.24

Accordingly, since 50 percent of the net income from the properties as thus computed was less than 27½ percent of the gross income, the Commissioner limited the depletion allowance to $111,962.24. The taxpayer claimed that the $606,051.66 development expense deducted from gross income in computing its taxable net income should not be deducted to determine the net income from the properties in applying the 50 percent limitation. Thus, under the taxpayer's computation, the net income for depletion purposes would be $829,976.14 (i. e., $1,001,375.17 gross income minus $171,399.03 production expense), and 50 percent thereof would not be less than 27½ percent of the gross income which it claimed in full as its depletion allowance.

Similarly, for the year 1930, the gross income from the properties was $370,448.72; the production expense, $285,390.90; and the development expense, $279,927.04. The total expenses were thus $565,317.94, which completely wiped out any taxable net income from the properties. The Commissioner, therefore, ruled that no depletion could be

allowed under the 27½ percent provision.[3] The taxpayer, however, contended that the development expense should not have been deducted for the purpose of Section 114 (b) (3), and that under its computation the net income would be $85,057.82 (i. e., $370,448.72 gross income minus $285,390.90 production expenses). Accordingly it claimed the arbitrary depletion allowance to the extent of one-half of the net income as computed by it, or $42,528.91.

The so-called development expense which the taxpayer deducted in computing its taxable net income but not in computing its net income for the purposes of Section 114 (b) (3) related to the exploration and drilling of wells on the properties. They consisted of such items as labor, supplies, tool rental, repairs to drilling equipment, as well as depreciation upon drilling equipment, such as derricks, casings, machinery, and tools (R. 52, items 1 and 2).

The Board of Tax Appeals held that the development expense need not be deducted in computing the 50-percent limitation, and the Circuit Court of Appeals, one judge dissenting, affirmed.

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[3] This ruling did not mean that the taxpayer was denied any allowance for depletion. On the contrary, it was entitled to all the depletion actually sustained during the year, for Section 114 (b) (3) specifically provides that the depletion allowance shall in no case be less than it would be if computed without reference to the arbitrary provisions there set forth.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the depletion allowance under Section 114 (b) (3) of the Revenue Act of 1928 should be computed without taking into consideration development expenditures and the related depreciation, which items were claimed by the respondent and allowed as deductions in computing the taxable net income for the years in controversy.

2. In holding that development expenditures and the related depreciation, which items the respondent elected to deduct currently, should not be deducted in computing "the net income * * * from the property" under Section 114 (b) (3) of the Revenue Act of 1928.

3. In failing to reverse the judgment of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

Section 114 (b) (3) of the 1928 Act provides that the allowance for depletion "shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property." In determining its taxable net income, respondent deducted development expenses from gross income, in accordance with permission granted to it by the Treasury Regulations. Nevertheless, it claims that it need not deduct those expenses for the purpose of computing the depletion allowance.

The parenthetical clause in Section 114 (b) (3) excludes only the depletion allowance itself in the determination of net income thereunder. The specific direction that depletion is to be excluded from the computation precludes the exclusion of any other deductible items, such as development expenses.

The regulations promulgated under the Revenue Act of 1928 provide that development expenses (if a taxpayer has elected to deduct them in computing taxable net income) shall be included in the computation of the net income from the property, for the purpose of the 50 percent limitation. And the provision thus limiting the depletion deduction to 50 percent of the net income from the property has been reenacted without change in the Revenue Acts of 1932, 1934, 1936, and 1938. These reenactments constitute legislative approval of the regulations.

The practical effect of the decision of the court below is to permit a double deduction for the same expense. There is nothing in the statute to indidate that Congress intended to allow a double deduction, and such a construction should, if possible, be avoided.

The theory of depletion is that it represents capital extracted from the property. Therefore, if the taxpayer elects to deduct development expenses from current income, it should not be permitted to recover again the same expenditures through the

form of depletion allowances, since it has already had its capital restored. That Congress intended that development expense should be deducted from the gross income in arriving at the net income from the property is shown by the legislative history of the provisions in question.

ARGUMENT

THE DEDUCTIONS TAKEN IN COMPUTING TAXABLE NET INCOME SHOULD LIKEWISE BE TAKEN INTO ACCOUNT IN COMPUTING ALLOWABLE DEPLETION UNDER SECTION 114 (b) (3)

1. Since a mine or oil well represents a wasting asset it is apparent that the receipts therefrom do not constitute true profit to the owner, unless there be charged against those receipts a proportionate part of his capital investment which is being depleted. "The deduction is permitted as an act of grace. It is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production." *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, 366; *United States* v. *Ludey*, 274 U. S. 295, 302.

The basic statutory provisions which thus permit the deductions from gross income on account of depletion of mines, oil and gas wells, and other natural deposits are contained in Section 23 (l) of the Revenue Act of 1928. But, in addition, Congress has singled out oil and gas wells for favored treatment by allowing an alternative arbitrary depletion deduction equal to 27½ percent of the gross

income from the property during the taxable year. Section 114 (b) (3) of the Revenue Act of 1928.[4] However, that artificial allowance is limited not to exceed 50 percent of "the net income of the taxpayer (computed without allowance for depletion) from the property * * *." Section 114 (b) (3).[5]

The present case deals with that 50 percent limitation, and arises in the following manner:

In the drilling of oil wells, as distinguished from actual production of oil after the wells have been drilled, numerous incidental expenses are generally incurred for wages, fuel, repairs, hauling, etc., which are generically described as development expenses, or intangible drilling or development expenses. The question had arisen years ago as to whether such expenditures were deductible from gross income as business expenses or whether they were in the nature of capital outlays. Admittedly, they were on the borderline between deductible business expenses and nondeductible capital outlays. Therefore, in recognition of the doubtful character of such expenditures, the Treasury

[4] These provisions first appeared in the law as Section 204 (c) (2) of the Revenue Act of 1926 (c. 27, 44 Stat. 9), and were thereafter reenacted without substantial change as Section 114 (b) (3) of the Revenue Acts of 1928, *infra*, 1932 (c. 209, 47 Stat. 169), 1934 (c. 277, 48 Stat. 680), 1936 (c. 829, 49 Stat. 1014), and 1938 (c. 289, 52 Stat. 447).

[5] In every instance, however, the taxpayer is guaranteed a deduction for at least the actual depletion sustained, for Section 114 (b) (3) provides that "in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

Regulations gave each taxpayer an option either to deduct such expenditures as business expenses or to capitalize them.[6] These regulations have been held to be valid. *Ramsey* v. *Commissioner*, 66 F. (2d) 316 (C. C. A. 10th), certiorari denied, 290 U. S. 673; *Grison Oil Corp.* v. *Commissioner*, 96 F. (2d) 125 (C. C. A. 10th), certiorari denied, 305 U. S. 613. Cf. *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459.

In the instant case, the taxpayer had elected to treat such expenditures as business expenses and during the years 1929 and 1930 it claimed and was allowed deductions in the respective amounts of $606,051.66 and $279,927.04 on account of such expenditures (R. 52–53). But, after having thus taken advantage of those deductions in the computation of its taxable net income, it then claimed, in

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[6] All the regulations, beginning with those issued under the Revenue Act of 1918, have offered that election, but have provided that once made it would be binding for subsequent years. Regulations 45, Article 223; Regulations 62, Article 223; Regulations 65, Article 225; Regulations 69, Article 223; promulgated, respectively, under the Revenue Acts of 1918, 1921, 1924, and 1926.

In view of the new basis for depletion provided in the Revenue Act of 1926 (i. e., the 27½ percent deduction), a new election binding upon all subsequent years was permitted. T. D. 4025, VI–1 Cum. Bull. 75 (1927). Thereafter, the regulations in somewhat greater detail continued the option as before. Regulations 74, Article 243; Regulations 77, Article 236; Regulations 86, Article 23 (m)–16; Regulations 94, Article 23 (m)–16; and Regulations 101, Article 23 (m)–16; promulgated, respectively, under the Revenue Acts of 1928, 1932, 1934, 1936, and 1938.

the same tax return, that the deductions were in the nature of capital outlays to be charged to capital account rather than to be deducted from gross income for the purpose of computing net income from the property in applying the 50 percent limitation on the depletion allowance. It is our position that these expenses must be treated consistently; that if the taxpayer enjoys the privilege of deducting them from gross income for the purpose of reducing its taxable net income it should likewise be compelled to treat them as deductions in applying the 50 percent limitation in Section 114 (b) (3). To hold otherwise, as was done by the court below, would result in part at least in according the taxpayer a double deduction with respect to the same expenditures.

2. Once these expenses have been deducted in computing taxable net income, they do not differ from any other kind of business expenses or current deductions in connection with the property, and therefore may not be ignored in determining the net income upon which the depletion deduction is based. It is hardly likely that Congress meant "net income" to be one thing for the purpose of imposing the basic tax and another thing for the purpose of computing the depletion allowance. Had it intended so contradictory a result, it would undoubtedly have taken pains to make that purpose clear.

This conclusion is fortified by the language and structure of Section 114 (b) (3). It provides that

the depletion allowance "shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property." Net income consists of gross income less the allowable deductions, and, since depletion is an allowable deduction, Congress specifically excluded it by the parenthetical clause. Had it desired to exclude any other allowable deductions from the computation, it would have similarly specifically mentioned them. The case calls for the application of the familiar rule of statutory construction embodied in the maxim *expressio unius est exclusio alterius.* The specific direction that depletion is to be excluded from the computation in determining the net income precludes the exclusion of any other deductible item. Cf. *Helvering* v. *Stockholms &c. Bank,* 293 U. S. 84, 90; *Arthur* v. *Cumming,* 91 U. S. 362, 363–364.

In *Helvering* v. *Mountain Producers Corporation,* 303 U. S. 376, 382, this Court held that the term "gross income from the property" means the gross income from oil and gas and that the term should be taken in its natural sense. We believe that the term "net income * * * from the property" likewise should be taken in its natural sense and that it means the actual net income from the property, not some theoretical figure which is arrived at by excluding a portion of the actual deductible expenses.

3. The Government's position is supported by administrative practice of some twelve years'

standing, and follows precisely Treasury Regulations that have been promulgated under five successive revenue Acts. The applicable Regulations have the sanction not merely of the general provisions of the revenue Act authorizing the issuance of "all needful rules and regulations" (Section 62 of the Revenue Act of 1928), but are more specifically founded upon Section 23 (l) of the 1928 Act, which, after granting a reasonable allowance for depletion, provides that such allowance is "in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary." Pursuant to that authority, Article 221 (i) of Regulations 74 lays down the following rule:

> The phrase "net income of the taxpayer (computed without allowance for depletion)" means the gross income from the sale of oil and gas less the deductions in respect to the property upon which depletion is claimed, including overhead and operating expenses, *development expenses (if the taxpayer has elected to deduct development expenses)*, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. * * * [Italics supplied.]

Like provisions appear in Article 221 (h) of Regulations 77, promulgated under the Revenue Act of 1932; Article 23 (m)–1 (h) of Regulations 86, promulgated under the Revenue Act of 1934; Article 23 (m)–1 (h) of Regulations 94, promulgated un-

der the Revenue Act of 1936; and Article 23 (m)-1 (h) of Regulations 101, promulgated under the Revenue Act of 1938.

These regulations unambiguously cover the present case. They declare that in determining net income for the purpose of the depletion limitation, development expenses must be subtracted if the taxpayer has elected to deduct them as expenses. Only by holding these regulations invalid can the result below be sustained. But we respectfully submit that these regulations are reasonable, and that the Commissioner of Internal Revenue has not exceeded his power in issuing them. Not only are they entitled to enjoy the presumption of correctness which usually attaches to an administrative construction, but they are more, in addition, considerably more than an administrative interpretation of the statute. They have behind them the provisions of Section 23 (l) spelling out with particularity the fact that the "reasonable allowance" for depletion in all cases must be under rules and regulations to be prescribed by the Commissioner. These regulations are therefore legislative in character rather than purely interpretative. The Commissioner was acting well within the scope of his discretion when he ruled that a reasonable allowance for depletion does not include, in effect, a double deduction—or partially double deduction—on account of development expenditures. Neither the Board of Tax Appeals nor the court below had authority to declare these regulations invalid

merely because they differed with the Commissioner as to his exercise of discretion in prescribing the terms and conditions upon which the depletion allowance would be permitted.

Moreover, even if the latitude open to the Commissioner were merely that ordinarily permissible in the case of purely interpretative rulings, these regulations would nevertheless be controlling. In substance, the same provisions appeared again in regulations issued under the Revenue Acts of 1932, 1934, 1936, and 1938, which reenacted the pertinent statutory provisions without change. Under the familiar rule such repeated reenactment carries with it legislative approval of the regulations. *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Hassett* v. *Welch*, 303 U. S. 303, 312; *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459, 466; *Brewster* v. *Gage*, 280 U. S. 327, 337.

This rule applies with equal force where the taxable year precedes the reenactments and is governed by the original statute rather than where it is governed by one of the reenacting statutes. *Brewster* v. *Gage, supra*; *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, 307–308; *Reinecke* v. *Smith*, 289 U. S. 172, 175. The court below therefore plainly erred when it held (R. 75) that the reenactments beginning in 1932 could have no bearing upon the construction of the identical provisions in the Revenue Act of 1928 as set forth in the regulations promulgated thereunder and as applied to the years 1929 and 1930.

4. The practical effect of the decision below is to permit a double deduction for the same expense, since the taxpayer immediately secures a deduction of 100 per cent of the development expense when the amount is deducted in computing taxable net income, plus a further deduction when the sum is excluded from depletion computation.[7] Yet this Court has repeatedly declared that taxing statutes should be construed, if possible, to avoid such an anomalous result. In *Ilfeld Co.* v. *Hernandez*, 292 U. S. 62, the Court, in speaking of a claim for a deduction, which, if permitted, would have been the equivalent of a double deduction for the same item, said (p. 68):

> If allowed, this would be the practical equivalent of double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers.

See also *McLaughlin* v. *Pacific Lumber Co.*, 293 U. S. 351, 355; *Burnet* v. *Aluminum Goods Co.*, 287 U. S. 544, 550; *United States* v. *Ludey*, 274 U. S. 295, 301.

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[7] Whenever the 50 percent limitation comes into play, the depletion deduction is a factor of the deductions from gross income. Under those circumstances, the development expenses will reduce taxable income whether charged as a current expense in computing the basic net income or charged to capital with a resulting increase in the net income which limits the depletion deduction. To use it in both ways is to have one expense serve double duty in producing deductions from taxable income.

There is nothing in Section 114 (b) (3) to indicate that Congress intended to allow a double deduction and such a construction should be avoided, since deductions are allowable only when plainly authorized. *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; *Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686, 689–690; *Ilfeld Co.* v. *Hernandez, supra*, at 66.

Furthermore, depletion is but a return of capital, since it represents capital extracted from the property. And the fact that the deduction is based upon an arbitrary percentage of the gross or net income from the property in no way changes the fundamental theory of the allowance. *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, 367; *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459, 467. Therefore, if a taxpayer deducts development expenses from current income, he should not be permitted to recover again the same expenditures through the form of depletion allowances. In deducting such expenses from current income, he has had his capital restored to him, and any further allowance would be in addition to the "reasonable allowance" contemplated by the statute.

5. Although the statute here involved is the Revenue Act of 1928, the opinion of the court below seems to be predicated largely upon earlier statutes (beginning with the Revenue Act of 1921) and regulations which are quite different. The statutory provisions here involved, granting the arbitrary 27½ per cent depletion allowance in the case of oil and gas wells are contained in Section 114

(b) (3) of the 1928 Act, and appeared in the law for the first time as Section 204 (c) (2) of the Revenue Act of 1926.

The provisions relied upon by the court below, on the other hand, first appeared as Sections 214 (a) (10) and 234 (a) (9) of the Revenue Act of 1921. Those sections deal with depletion generally (not limited to oil and gas wells), and provide for an allowance based upon "discovery value," and not upon any percentage of gross receipts. The deduction was limited not to "exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made * * *." Sections 214 (a) (10) and 234 (a) (9) of the Revenue Act of 1921. And the Treasury Regulations issued thereunder (Regulations 62, Article 201 (h)) spoke of net income as meaning gross income from the property less "operating expenses." Similar statutory provisions appeared in the Revenue Act of 1924, except that the limitation was reduced to fifty percent (Section 204 (c)), and Regulations 65, Article 201 (h), issued thereunder continued the provisions of the predecessor regulations.*

* The court below seems to assume that the same provisions were also present in the regulations issued under the 1926 Act. (R. 74, footnote 5.) But those provisions merely dealt with discovery depletion which was continued in the 1926 Act only in the case of mines, etc., but not in the case of oil and gas wells. As to the latter, the statute for the first time provided for percentage depletion, and the regulations issued under the 1926 Act dealing with percentage depletion contain no such provisions.

The court below seized upon the phrase "operating expenses" as it appeared in those early regulations; concluded that they did not embrace development expenses; and therefore held that the term "net income" thereupon became so irrevocably fixed in the law that new regulations taking a contrary position must of necessity be fatally defective, although issued under different provisions of a later statute (Revenue Act of 1928) and operating prospectively only. We respectfully submit that the court erred.

(a) Even if the earlier regulations had been issued under identical statutory provisions, and even though they had unambiguously covered the present situation, then nevertheless the Commissioner would have been empowered to issue different regulations under the later statute which would operate with prospective effect only.

The statute itself recognizes the power to issue new regulations which change the rule of liability. Section 605 of the Revenue Act of 1928, amending Section 1108 (a) of the Revenue Act of 1926, plainly states:

> In case a regulation or Treasury decision relating to the internal-revenue laws is amended by a subsequent regulation or Treasury decision, made by the Secretary or by the Commissioner with the approval of the Secretary, such subsequent regulation or Treasury decision may, with the approval of the Secretary, be applied without retroactive effect.

Moreover, this Court has in at least two cases given effect to amended regulations, notwithstanding the reenactment of the statutory provisions while the former regulations were in force. *Morrissey v. Commissioner*, 296 U. S. 344; *Murphy Oil Co. v. Burnet*, 287 U. S. 299.

In the *Morrissey* case, regulations defining the term "association" were promulgated under the Revenue Acts of 1918 and 1921. Thereafter, under a subsequent statute, new regulations were issued which radically modified the earlier definition. The Court held the later regulations were to be applied despite legislative reenactment during the continuance of the earlier regulations, and stressed the necessary and appropriate range of administrative power to reexamine and reformulate its rules (pp. 354–355):

> As the statute merely provided that the term "corporation" should include "associations," without further definition, the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction. Nor can this authority be deemed to be so restricted that the regulations, once issued, could not later be clarified or enlarged so as to meet administrative exigencies or conform to judicial decision. * * * We find no ground for the contention that by the enactment of the Revenue Act of 1924 the Department was limited

to its previous regulations as to associations. * * *

In the *Murphy Oil Co.* case, the Treasury Department in 1926 changed its regulations which had been in force for over six years with respect to the application of the depletion allowance to bonuses received by a lessor of oil properties (pp. 303–304). This Court approved the amended regulations, noting that they "must be taken to have received the approval of Congress," since the applicable statutory provisions had been thereafter reenacted in 1928 and 1932 (p. 307). Similarly here, the provisions of the 1928 Act relied upon by the Government were reenacted in 1932, 1934, 1936, and 1938.

The court below committed serious error by refusing to give effect to the 1932 reenactment (R. 75). Regulations had been promulgated early in 1929 under the Revenue Act of 1928 which specifically covered the present case and governed the years 1929 and 1930, here involved. The holding of the court below leads to the extraordinary conclusion that where the Commissioner finds it desirable under a newly enacted statute to promulgate regulations different from those issued under preexisting law, and actually does promulgate different provisions, those new provisions can never be given any legal effect under that statute although they are limited to prospective operation only. In short, the Commissioner is compelled by the new Revenue Act to issue new regulations but is without any

power to apply them. One supposes they might serve the purpose of notice that similar new regulations would be issued, and would then be applied, under the next revenue act, when and if enacted. It is impossible that Congress could have intended to require regulations which served only as dress rehearsal, or to strait-jacket the administrative process by imposing a waiting period of an indefinite number of years.

The instant case is sharply to be distinguished from *Helvering* v. *Reynolds Co.*, 306 U. S. 110, where the Court refused to permit an amended regulation to apply with *retroactive* effect. There the new ruling appeared for the first time in 1934 and the question was whether it could be applied to transactions fully consummated during the year 1929, thereby affecting the tax liability for that year. Here, on the other hand, the regulations apply prospectively only. They were issued under the Revenue Act of 1928 early in 1929, and the tax years involved are 1929 and 1930. Moreover, these regulations were foreshadowed by G. C. M. 2315, VI-2 Cumulative Bulletin 21, issued in September, 1927, in which it was stated that thereafter[*] (p. 22):

> if a taxpayer elects to treat development expenditures as ordinary and necessary business expenses * * * in computing tax-

[*] While it is true that that ruling was issued merely as an opinion of the General Counsel of the Treasury rather than as an official Treasury Decision and therefore is not entitled

able net income, such expenditures must be deducted in determining the net income from the property, which amount is used as a limitation in the computation of the depletion allowance based on income.

(b) In the foregoing discussion we have endeavored to show that even if the statutory provisions relating to percentage depletion here involved were present in the Revenue Acts of 1921 and 1924, then nevertheless the Commissioner would have been entitled to change his construction of those provisions in the 1928 Act. But our case is stronger. The provisions for percentage depletion did not appear until the Revenue Act of 1926. Under that statute, the Commissioner made no ruling as to the meaning of the term "net income" as applied to percentage depletion of oil and gas properties.[10] His first official ruling in regard to the computation of net income under the arbitrary oil-depletion provision was made under the succeeding statute

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to the same weight as a Treasury Decision, nevertheless it was published and circulated as widely as a Treasury Decision, and in fact accurately described both the past and future practice of the Treasury.

[10] However, after the issuance of G. C. M. 2315, *supra*, in September 1927, the Treasury in fact did undertake under the 1926 Act, to follow the practice later set forth in the regulations here involved. In *Ambassador Petroleum Co.* v. *Commissioner*, 81 F. (2d) 474 (C. C. A. 9th), the same court below ruled against the Government in a case arising under the 1926 Act. The Government did not ask for further review in that case, but rather waited for the instant case where the question of the validity of the new regulations could squarely be presented to this Court.

and is the very one under attack in the instant case.

(c) True, there were somewhat comparable provisions relating to discovery depletion in the 1921 and 1924 Acts, as well as in the 1926 Act, to the extent that natural resources other than oil and gas properties were involved. And the regulations issued under those provisions could be regarded as construing "net income" in accord with the position maintained by the taxpayer herein.[11] But if the legislative history of these provisions is examined, it will be found that even they were not correctly interpreted in the early regulations relied upon by the taxpayer and the court below.

Those provisions imposed a limitation upon the amount of depletion allowable based upon discovery value. Section 214 (a) (10) of the 1921 Act provided that the allowance "shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery

[11] Those regulations were not unambiguous. The critical words upon which the taxpayer and the court below relied are "operating profit" and "operating expense." From these words, it is necessary to go one step further and say that they excluded consideration of development expenses. Similar phrases appeared, as the taxpayer will no doubt point out, in the legislative history of some of the early statutes. But it is equally arguable that such phraseology was no more than a convenient locution to describe net income from or expenses chargeable to the operation of certain properties, without any attempt at segregation of the varying types of deductible expenses.

is made * * *."[12] The reason for this limitation was explained by the Senate Committee on Finance. The committee stated (S. Rept. No. 275, 67th Cong., 1st Sess., p. 15) that the limitation was imposed—

> in order to make it certain that the depletion deduction when based upon discovery value shall not be permitted to offset or cancel profits derived by the taxpayer from a separate and distinct line of business. * * *

In other words, although Congress was willing to let the taxpayer employ the depletion deduction to absorb any taxable gain from the property involved, it was not willing to permit the use of that deduction to offset profits realized by the taxpayer from other sources.

But the construction which the taxpayer seeks to perpetuate accomplishes the very thing that Congress attempted to guard against. For example, consider the figures in this very case with respect to the year 1930. By deducting development expenses in the computation of its taxable net income, the taxpayer not only eliminated all taxable

[12] Beginning with the Revenue Act of 1924 the deduction was further restricted so as not to exceed 50 percent of the net income from the property.

The court below seemed to find this reduction, when considered with a conjectured increase in oil prices and in tax rates, a sufficient reason to disregard the anomalous consequence of double deductions (R. 77–78).

income from the four properties involved, but also obtained the benefit of a $194,869.22 loss:

Gross income from the properties		$370,448.72
Deductions:		
Production Expense	$285,390.90	
Development Expense	279,927.04	
Total Expense		565,317.94
Loss		194,869.22

The Commissioner therefore ruled that since the percentage depletion allowance was limited to 50 percent of the net income from the properties and since the taxpayer had no net income from the properties, no deduction on account of percentage depletion could be allowed. The taxpayer, on the other hand, by failing to deduct the development expenses in the application of the 50 percent limitation, arrived at the following result:

Gross income from the properties	$370,448.72
Deduction: Production Expense	285,390.90
Net income	85,057.82
Depletion deduction (50 percent of the net income)	42,528.91

Thus, if this result is permitted to stand, the taxpayer not only has no taxable income from these properties, and not only has a loss of $194,869.22 arising out of them which it can employ against income from other sources but it will also have an artificial depletion allowance of $42,528.91 which it can likewise use to reduce taxable income realized from other activities. This is the very result which Congress sought to prevent.

Moreover the history of the Revenue Act of 1926 shows that when that legislation was under consideration by Congress it was the general understanding that development expenses constituted a part of the operating expense of the property. This is shown by the statement of L. C. Manson, Esq., a depletion expert and counsel for the Senate Select Committee Investigating the Bureau of Internal Revenue, made at the hearings before the Committee on Finance on H. R. 1, 69th Cong., 1st Sess., which eventually became the Revenue Act of 1926. Senator Jones, of New Mexico, inquired whether the old, established companies charged the development expense to the cost of operation or whether they capitalized it. Mr. Manson replied that most of them charge it to the cost of operation, and that such expense is deducted from their tax as an operating expense. See full text of colloquy in Appendix B, *infra*, pp. 32–34.

6. The respondent's position is also contrary in principle to the sound result reached in *Ramsey* v. *Commissioner*, 66 F. (2d) 316 (C. C. A. 10th), where a taxpayer had similarly deducted development expenses currently in accordance with the option given him by the regulations. In a later year he sold the properties, and in returning the profit on sale added to cost the development expenditures which he had theretofore deducted as expenses. The Commissioner denied this double deduction, holding that since the taxpayer had exercised his

option to deduct the items as business expenses, he could not later treat them as additions to capital. The Circuit Court of Appeals stated (p. 318) that the question presented was "whether the regulation may permit the irrecoverable costs of drilling oil wells to be classed as an expense of *operation* rather than as a 'permanent improvement or betterment'" [italics supplied], and thereupon upheld the Commissioner. This Court denied certiorari, 290 U. S. 673. See also *Grison Oil Corp.* v. *Commissioner*, 96 F. (2d) 125 (C. C. A. 10th), certiorari denied, 305 U. S. 613.

The same principle applies here. Just as the taxpayer in the *Ramsey* case, having elected to deduct development expenses from current income, could not thereupon classify them as capital outlays for the purpose of recovering a greater amount of capital upon sale, so here the taxpayer should not be permitted in the same tax return to change its position by charging these expenditures to capital for the sole purpose of increasing the depletion allowance.

CONCLUSION

Under the last clause in Section 114 (b) (3) the taxpayer is entitled to the full amount of depletion actually sustained by it. The only question here is the extent to which it is entitled to claim the arbitrary percentage allowance over and above the actual depletion. The statute limits that arbitrary allowance to 50 percent of the net income

from the property computed without allowance for depletion. Here the taxpayer has enjoyed the advantage of deducting development expenditures from taxable gross income. Both the statute and regulations require consistent treatment of those expenditures in applying the 50 percent limitation. The judgment below should be reversed.

Respectfully submitted.

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SEPTEMBER 1939.

APPENDIX A

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for depletion.*—

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 221. *Depletion of mines, oil and gas wells; depreciation of improvements.*—* * *

* * * * *

(i) "Depletion allowance based on the income from oil and gas wells": The deduction for depletion based on the income from oil and gas wells shall not exceed 50 percent of the net income of the taxpayer, computed without allowance for depletion, from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to the income from the property. The phrase "net income of the taxpayer (computed without allowance for depletion)" means the gross income from the sale of oil and gas less the deductions in respect to the property upon which depletion is claimed, including overhead and operating expenses, development expenses (if the taxpayer has elected to deduct development expenses), depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. * * *

* * * * *

ART. 243. *Charges to capital and to expense in the case of oil and gas wells.*— Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *

APPENDIX B

Hearings of the Senate Committee on Finance on H. R. 1, 69th Cong., 1st Sess., pp. 163, 200:

Senator JONES of New Mexico. Before you leave that oil business, I want to clear up a point in my own mind. You take the old established oil companies that are also engaged in developing new properties, in prospecting. Do they charge the expenses of that prospecting to the *cost of operation?*

Mr. MANSON. Yes.

Senator JONES of New Mexico. Or capitalize it?

Mr. MANSON. No; most of them charge it to *cost of operation.*

Senator JONES of New Mexico. What is the effect of that?

Mr. MANSON. *The money they spend in prospecting is deducted from their tax as an operating expense,* and, in addition to that, they get discovery value on the property. [Italics supplied.]

* * * * *

Senator JONES of New Mexico. Now, we have this situation with respect to the oil industry. We have the large companies which try to keep up their replacement through charges to expense of operation, and deduct that from their net income. That is being done now, as I understand it, in a large percentage of the cases. But there is a large number of other concerns starting into the business which have no net income from any source from which they can deduct the expense of exploration.

Now it seems to me that there should be a uniform provision put in there so that those concerns shall be put upon the same basis, and the company which charges exploration to expense takes no hazard to that expense in carrying on its operation, and is not entitled to the same discovery value, we will call it, or depletion value on account of discovery that the other concern is.

The CHAIRMAN. Well, Senator Jones, that happens today. You or I go out onto the range now and wildcat and we spend our money; no one gets any credit for that, and why should they? That is an investment that the man makes. That is what you or I do; we are going to bet that we are going to get some oil here. But if we do find it then it is exactly the same as the metal mine, and we have got to keep up that exploration, or else we would not have any profit.

Senator JONES of New Mexico. I understand that, Senator. I am not warring against that thought at all, but if a large percentage of the concerns use capital in the development process then it seems to me that all concerns ought to charge these development operations to capital account and not reduce their net income from other sources by reason of that.

Senator REED of Pennsylvania. In other words, they ought to be compelled to form their accounts on the same basis.

Senator JONES of New Mexico. That is the idea.

Senator REED of Pennsylvania. One man should not put his drilling expense into capital account and the other charge it off to expense for the purpose of taxation.

Senator JONES of New Mexico. Yes.

Senator REED of Pennsylvania. Whatever he may do on his books.

Senator JONES of New Mexico. Yes, whatever he may do on his books for the company's statements, and so on, that is one thing, but I think for taxation purposes they ought to all be put on the same basis.

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